PERAC MEMO #32/1999

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To: All Retirement Boards and Staff

From: Joseph E. Connarton, Acting Executive Director

Subject: New Investment Guidelines

The PERAC Investment Unit has developed three new investment guidelines which are intended to offer the retirement boards increased flexibility with which to accomplish their investment objectives.

The guidelines pertain to:

1) Expediting the ability of a system to subscribe to a new offering by an alternative assets partnership manager with whom it has previously invested.

2) Permitting a modest modification to an investment manager's mandate in certain cases.

3) Allowing the limited use of certain interest rate financial futures and options solely as a duration management tool within an investment manager's mandated duration range, and allowing the limited use of equity index financial futures and options as a short-term liquidity tool within a manager's existing mandate.

More complete descriptions of these guidelines are attached. As discussed therein, boards may follow these guidelines subject to PERAC approval of an appropriate supplementary regulation request and the submission of other required information. Please address any questions or comments to the PERAC Investment Unit.

Interest rate financial futures and options, such as US Treasury Bond contracts and options written against those contracts, can be used as effective tools in managing duration in fixed income portfolios. Selling futures contracts or purchasing put options can accomplish the shortening of portfolio duration in anticipation of higher interest rates. Such short-term use of these instruments can be an appropriate alternative to liquidating income-producing securities intended for long-term holding periods. Purchasing futures contracts or call options can accomplish the lengthening of portfolio duration in anticipation of lower interest rates. Such short-term use of these instruments can be an appropriate strategy if the portfolio manager is temporarily unable to purchase appropriate traditional securities in order to achieve the portfolio's duration targets.

Use of interest rate financial futures and options for purposes of short-term duration management is limited to 25% of the portfolio's net assets, as measured by the par value of securities corresponding to the futures contracts held either in long or short positions and/or the par value of securities covered by respective option contracts. The effective duration after taking into account the use of these instruments should never be outside the upper or lower targeted duration ranges for the portfolio as contained in the retirement board's investment objectives and policies.

There are also active markets in financial futures and options that track major stock market indices including the Dow Jones Industrial Average and the Standard & Poor's 500. These instruments are used by institutional investors as well as mutual funds, including some of the largest index funds in the industry, as a source of short term liquidity that allows the portfolio manager to mimic the indices' performance while keeping cash in reserve that would ordinarily be earmarked for purchase of specific equity securities. Correspondingly, they can also be used in the short-term as a way for managers to modestly reduce their portfolios' exposure to the market in lieu of selling specific stocks. Use of futures and options for these purposes should not effectively exceed 10% of the portfolio, and use of these instruments for purposes other than as discussed here is not permitted.

Consistent with these guidelines, PERAC will approve supplementary regulations concerning Prohibited Investments (840 CMR 21.01). Retirement boards should incorporate these changes in amended statements of investment objectives and policies.

INVESTMENT GUIDELINE 99-2

There may be circumstances where a board wishes to make a modest modification or adjustment to its mandate with an existing investment manager. An example would be allowing a fixed income “core” manager to invest in one or more additional segments of the market (such as high yield bonds or international securities) up to a certain limited percentage of that manager’s aggregate bond portfolio. PERAC will consider and evaluate requests for such modifications on an individual basis.

In obtaining approval for such modifications to a current investment contract, a retirement board should submit a request for a supplementary regulation relative to the normal procurement process for an investment-related service (840 CMR 16.08). This request should address and provide documentation for the following questions and issues: 1) how the proposed modification fits in under the board’s investment objectives and strategies, 2) the nature of the board’s relationship with the investment manager, including length of the existing contract, investment performance over time relative to existing benchmarks, and the overall quality of client service, 3) the investment manager’s staffing and performance record in the market segment(s) covered by the new mandate, and 4) whether a new benchmark for performance has been or should be selected for the portfolio.

Requests for a modification in mandate should generally involve investments within the same broad asset class and should not involve any substantive deviations from the manager’s basic investment style. Contracts governing the relationship should be amended to reflect the change(s).

This guideline does not permit major changes to an investment mandate, such as giving a manahger hired for growth stocks authority to add a value stock mandate or allowing a manager with a large-cap equity mandate to add small caps. For such major changes in mandate, new competitive processes are still required.

INVESTMENT GUIDELINE 99-3

Retirement boards may request authority to commit funds to new partnerships offered by alternative investments project managers with whom they have already invested. An example would be a board that has invested in a hypothetical Venture Capital V and has voted to invest in Venture Capital VI. When a board elects such a course as a prudent exercise of its fiduciary responsibility, it may conclude that no purpose is served by drafting an RFP and undertaking a competitive process. Such a process may be deemed impractical not only because of the short time frame often involved in terms of committing to new partnerships but also because the board's existing relationship with the current project manager could well preclude a thorough and true competitive process.

In these cases, the board should submit an updated exemption application for the manager along with a request for a supplementary regulation relative to the normal procurement process for an investment-related service (840 CMR 16.08). This request should include documentation of the board's current financial relationship with the manager, including assets invested, length of contract, and investment performance results from existing projects, as well as an explanation of why a commitment to the manager's new project is consistent with the board's investment objectives and strategies.